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SIPDIS

SENSITIVE

TREASURY FOR INTERNATIONAL AFFAIRS - MMILLS AND CPLANTIER
NSC FOR BRYZA AND MCKIBBEN

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TAGS: [EFIN](#) [KTFN](#) [TU](#)
SUBJECT: MEETING WITH DEPUTY IMF RESREP

REF: A. ANKARA 2161

- [1B](#). ANKARA 2070
- [1C](#). ANKARA 1559
- [1D](#). ANKARA 1318
- [1E](#). ANKARA 1093
- [1F](#). ANKARA 812

[¶11. \(SBU\)](#) Summary: IMF Deputy Resrep confirmed press reports that all three prior actions are now completed and reiterated the expected timing for finalizing the new IMF program: signed Letter of Intent by end of April, board meeting mid-May. IMF staff expects the final version of the Regional Investment Incentives Law to be substantially scaled down in cost from earlier versions, and claims to have the Prime Minister's agreement on this. The Deputy Resrep said Turkey has become less financially vulnerable in recent years and said IMF staff will conduct a Financial Sector Assessment later this year, including looking at terrorism finance issues. End Summary.

Prior Actions Completed:

[¶12. \(SBU\)](#) In a April 19 meeting, IMF Deputy Resrep confirmed that April 14 passage of the Tax Administration Reform Law meant that all three prior actions for the IMF program had been completed. Though the President has not yet signed the bill into law, this was not a requirement under the program and the President is expected to sign. The other two prior actions--submission to parliament of the Banking Reform Law and the Social Security Reform Law--took place earlier. Actual passage of these two laws will not be required until the Second Review under the Program later this year.

[¶13. \(SBU\)](#) In terms of timing, the program is now going through the IMF's internal approval process and the Letter of Intent (LOI) should be ready for signature in time for Managing Director Rato's visit to Istanbul for the April 29 Investors Advisory Council. Though Minister Babacan has publicly stated there will be a board vote May 12, the Deputy Resrep said a date could not be fixed until the program document is ready. Nevertheless, he expects a board vote around May 12.

Regional Investment Incentives:

[¶14. \(SBU\)](#) On the contentious issue of expanded Regional Investment Incentives, the Deputy Resrep said that Fund staff expected the final version to be substantially scaled back in cost, such that the additional cost over what was budgeted for 2005 would only be between 100 and 200 million YTL (\$73-\$146 million). He claimed that the Prime Minister himself had agreed to this. Given the sensitivity of the Prime Minister appearing to have climbed down under IMF pressure, and parliamentary sensitivities, required GOT action on the Regional Investment Incentives will not be mentioned in the LOI, which is made public. On the other hand, the continual resurrection on the Turkish side of the idea of cutting VAT tax rates for the textile sector, has induced the IMF to put an explicit prohibition of such a move in the LOI. Last week, Minister Unakitan re-floated this idea, only to have the Resrep state publicly that this would be contrary to the GOT's commitments to the Fund.

Compensating Measures:

[¶15. \(SBU\)](#) The Deputy Resrep explained that the GOT does need to take compensating fiscal measures because of a combination of the additional costs of the Regional Investment Incentives and some other items. Pensions were increased more than assumed in the program, costing an additional 400 MM YTL (\$291 million). Also, since electricity prices have not been increased (despite higher fuel prices) there has been less VAT collected than assumed in the program. These three items add up to about 1.2 or 1.3% of GDP--hence the need for compensating measures. The GOT has opted to find this money

by cutting the revolving funds that state hospitals use to pay bonuses to doctors and nurses.

Reduced Financial Vulnerabilities:

16. (SBU) The Deputy Resrep said that Turkey had significantly reduced its vulnerability to a financial crisis over the past two years. He focused in particular on the fall in real interest rates : from 38.2 percent in 2002, to 34.8 percent in 2003 to 16.6 percent in 2004 and currently around 9 percent. On the risk that corporates were taking on excessive foreign exchange risk he pointed out that Turkish corporates tended to have low leverage, thereby increasing the likelihood they could withstand the shock of a sharp fall in the exchange rate. Treasury continues to have large rollover needs in the domestic market but the Deputy Resrep considered Treasury reserves to be adequate.

Financial Sector Assessment/Terror Finance:

17. (SBU) The Deputy Resrep said that the IMF had been awaiting passage of the new Banking Law before conducting a Financial Sector Assessment, one component of which was to look at controls on financial crime, including terrorism finance. He was not aware of Turkey's deficiencies on terrorism finance. The Financial Sector Assessment is now expected to take place later this year.

EDELMAN